3.01 Investments in Debt Securities – Trading

Securities Overview

There is a wide variety of investments an entity may decide to make, including the securities of other entities. Securities fall into two basic categories:

- Debt securities (eg, bonds are most common)
- Equity securities (ie, shares of stock and derivative instruments associated with stock)

The FASB Accounting Standards Codification (ASC) provides principles and guidance for accounting for securities under several different ASC topics:

- ASC 320 relates to investments in debt securities. Note that ASC 320 does *not* apply to:
  - Brokers and dealers (ASC 940)
  - Defined benefit pension and other postretirement or postemployment plans (ASC 960, 962, and 965)
  - Investment companies (ASC 946)
- ASC 321 relates to investments in equity securities.
- ASC 323 relates to the equity method of accounting for certain equity securities and joint ventures.
- ASC 325 relates to other investments, such as investments in insurance contracts and beneficial interests in securitized financial assets (not likely to be tested).

Debt Securities in General

Generally, if an entity acquires the debt securities of other entities, depending on the nature of the securities, it is essentially becoming a creditor with a receivable from the other entity. While holding the receivable, it will generally be receiving periodic interest payments and, depending on the terms of the instrument, also may be receiving periodic payments to reduce the principal. In other cases, the principal may be paid as a single lump sum at the end of the receivable's term.

The value of a receivable is equal to the present value of the payments to be received, applying an appropriate interest rate. The rate used may be the investor's cost of capital, the return on other investments, or some target based on whatever criteria the investing entity determines is applicable. The rate, and ultimate valuation, is adjusted to consider both market risk and credit risk.

- Market risk is the risk that a receivable will diminish in value due to:
  - A rise in market interest rates, making the lower rate less desirable, or
  - Other investments will become available that offer a greater return.
- Credit risk is the risk that the debtor will not perform, which could mean that some or all payments will be missed or late.

Some investments in debt securities are made for reasons other than the generation of regular cash flows (some do not provide interest and principal payments). Such investments may be made to:

- Benefit from gains on trades and other transactions
    - The value of securities is affected by a wide variety of factors, such as market interest rates, the issuing entity's credit rating, the availability of investment alternatives, or economic conditions. An investor may speculate that changes in one or more of these factors will lead to an increase in value.
- Balance out an investment portfolio
- Establish or enhance a fund for obtaining assets or retiring debt
- Enhance a relationship with the issuer of the security

The ASC defines a debt security as "any security representing a creditor relationship with an entity." The term "debt security" also includes:

- Preferred stock that by its terms either must be redeemed or is redeemable at the option of the investor
- A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (whether equity or debt) in the issuer's statement of financial position
- U.S. Treasury securities
- U.S. government agency securities
- Municipal securities
- Corporate bonds
- Convertible debt
- Commercial paper
- All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
- Interest-only and principal-only strips

The term "debt security" excludes:

- Option contracts
- Financial futures contracts
- Forward contracts
- Lease contracts
- Receivables that do not meet the definition of a security, such as:
    - Trade accounts receivable arising from sales on credit by industrial or commercial entities
    - Loans receivable arising from consumer, commercial, and real estate lending activities of lending institutions

Investments in debt securities are reported on an investor's balance sheet (B/S) in one of three categories:

- Trading Securities (HFT – Held For Trading) – Investments in debt instruments (eg, bonds), which the investor has acquired in an attempt to make profits by buying and selling within a short period of time.
    - Normally classified as current assets.

- Available-For-Sale (AFS) Securities – Investments in marketable debt instruments that do not fit the definitions of HTM or trading securities.
    - These may be classified as current or noncurrent assets, depending on the expected date of sale. If the holding period of the securities is indefinite, they should be classified as noncurrent assets.
- Held-To-Maturity (HTM) Securities – Investments in bonds and other debt instruments that the investor has the *ability and intent* to hold until the due date for repayment.
    - Classified as noncurrent assets until the maturity date is less than one year from the B/S date.
    - When principal is paid in installments, whether annually at the end of the term, or in some other pattern, the principal that will be paid within the next year is classified as a current asset.
    - If an entity has an operating cycle that exceeds a year, the current amount will be the principal amount to be paid within the next operating cycle.

Debt Securities Overview			
	Trading (HFT)	**Available for sale (AFS)**	**Held to maturity (HTM)**
Balance Sheet	Usually current Fair Value	Current/noncurrent Fair Value Amortized cost & allowance for credit losses (parenthetically) Unrealized gains/losses (other than credit losses) in OCI (Statement of Comprehensive Income) & accumulated OCI in Stockholders' Equity (separately)	Noncurrent/current Amortized cost Allowance for credit losses (separately)
Income Statement	Unrealized gains/losses Realized gain/loss Interest income	Credit loss expense/reversal Realized gain/loss Interest income	Credit loss expense/reversal Realized gain/loss Interest income
Statement of Cash Flows	Usually operating activity (purchase or sale)	Investing activity	Investing activity

Accounting for Trading Securities

Balance Sheet

Trading securities are initially recorded at cost, but they are carried at fair value (ASC 320). That is, carrying values of the securities are adjusted to their current market prices every period, including interim periods if interim F/S are prepared in addition to the annual F/S.

Income Statement

- Due to the marketable nature of these securities, and the intention to sell them in the near future, unrealized gains and losses (temporary) resulting from fluctuations in market price are reported in net income.
- Any realized gain or loss (permanent) from the sale or other disposal of these securities is also reported in net income.
- Interest income is also reported.

Statement of Cash Flows

- Since trading securities are generally purchased for the purpose of generating *profits from resale in the short term*, they are a *part of the entity's working capital*, and transactions are normally reported in the operating activities section of the statement of cash flows.
- Cash flows related to the acquisition (outflows) or disposal (inflows) of trading securities may be classified as operating or investing activities on the statement of cash flows, however, depending on the nature and purpose for which they were acquired:
  - When trading securities are acquired for short-term appreciation, they are reported as current assets and the cash flows are classified as operating activities on the statement of cash flows. This is the more common classification.
  - When trading securities are acquired for long-term appreciation, they are reported as noncurrent assets and the cash flows are classified as investing activities.

An entity acquires bonds of another entity with a cost and face value of $100. They are being held in anticipation of an increase in value due to an expected decrease in market interest rates. The following information relates to cost and market values.

Purchase price, 1/1/X1	$100
Fair value, 12/31/X1	$140
Fair value, 12/31/X2	$ 90

To purchase:

Investment in trading securities	100	
Cash		100

At 12/X1, the fair value is now $140, resulting in a gain of $40. Since the security must be reported at fair value, the increase is recorded in the investment account, or set up as a valuation allowance.

Market Adjustment – Trading Security (B/S)	40	
Unrealized Gain (I/S)		40

The market adjustment account is on the balance sheet and increases the carrying value of the trading security in the current asset section. The unrealized gain is on the income statement as part of income from continuing operations.

At 12/X2, the fair value is now $90, resulting in a loss of $50 ($140 – $90).

Unrealized Loss (I/S)	50	
Market Adjustment – Trading Security (B/S)		50

The income statement effect in 20X1 is $40, and in 20X2 is ($50). These amounts represent the current year effects only since they are both income statement items. The valuation allowance will have a credit balance of $10, resulting from a debit of $40 in 20X1 and a credit of $50 in 20X2.